

North Dakota Legislative Council
Energy Development and Transmission Committee
9 a.m.
Tuesday, March 1, 2022
Roughrider Room, State Capital, Bismarck
Russell R. Murphy
NARO North Dakota President



Introduction

Post Production Deductions can be very concerning to a royalty owner lessor. Deductions are difficult to understand and can be responsible for a large value deduction of the royalty payment.

NARO has urged royalty owners to consult a professional when offered a lease, as the lease provisions drive the ability for an operator to deduct. Some owners feel that even though their lease contains cost free provisions they are immune to deductions.

NARO understands that gas produced at the wellhead has a limited value. The gas needs to be processed to make it become marketable to receive a higher market price. Oil and gas producers are for profit businesses and need to make a profit to continue to conduct business.

North Dakota along with many other states contain case law that allows an operator to deduct what NARO believes to be “Reasonable Costs” prior to marketing. With that said, it is not uncommon to see gathering, drying, compression and transportation deductions of over 80% of the gas royalty. Unfortunately, some post production deductions borne by the royalty owner can be extreme.

Production Costs vs. Post-Production Costs

When a well is planned, it is usually the producer or lessee not the lessor who is responsible for all the associated costs to produce the well. Which can be termed as Production Costs.

Cost after the well is producing that may, or may not, be deductible when calculating the royalty generally include; taxes, dehydration, compression and transportation can be termed as Post-Production Deductions.

Lease

When a lessor reviews information supplied by the lessee for deductibility, the lessor should refer back to the agreed upon terms of the lease.

If the lease grants the deduction of the agreed upon share of cost, then the lessor may have little room to negotiate.

If the lease does not contain language addressing the cost to market gas, then the lessor may have the ability to have those cost returned.

Argument

NARO believes that a royalty should be cost free by definition. All deductions should be associated with the lessee or associated non operator working interest. When post production deduction are they should be in relation to contract or lease provisions, statutory, regulatory or legal standing within the state of production.

The relationship that exists between lessor and lessee has been tarnished by the lack of transparency. Numerous lessee operators have contracted with a related third party to handle the marketability of gas produced.

It seems unfathomable that a royalty taken from the lessor could by turn into a net negative to the lessor on their royalty payment.

Conclusion

The royalty owner or lessor and the lessee have a relationship that is of mutual dependence. The lessee needs the royalty owner to prospect, the lessor needs the lessee to prospect their mineral ownership.

NARO would ask the lessee be considerate to the lessor and be fair when considering the deductions passed on to the Lessor. Numerous times deductions are paid to a subsidiary of the lessee and little transparency exists. When this happens the lessee may express they have limited ability to control deductions. We all know this is somewhat inaccurate.

NARO also has experienced when a leasehold is sold to a new operator, the new operator has failed to review leases to confirm that deductions can be taken. This can be somewhat cumbersome to a lessor who historically has not experienced such deductions.

NARO also feels the lessor has taken advantage of the lessee and limited knowledge of the complexities of an oil and gas lease. Standardization within the state on post production deductions would ultimately help the relationships between parties.

Deductions should be borne by the lessee or a non-operator when not part of a statutory or regulatory relationship.

Determining the market price of gas produced can vary by lessee. Many leases contain language that would address where and how the gas is valued. NARO would argue that using "Comparable Sales Method" is the most fair. Using the valuations of a non-related party could reduce the abusive over assessment of deductions used when a related party is marketing the lessee produced gas.